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U.S. Congress. Senate. Committee on Finance.

Memorandum relative to pending Revenue Bill...

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[1916?]

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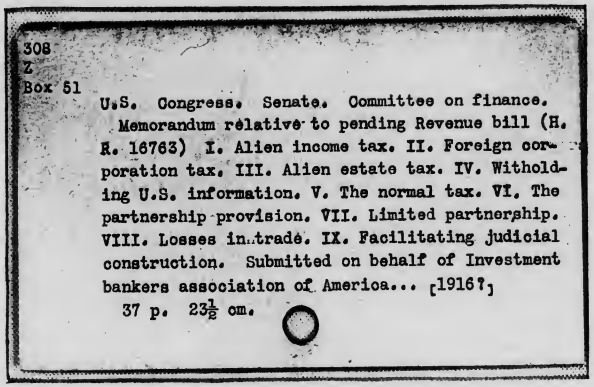

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U.S. Congress. Senate. Committee on finance. Memorandum relative to pending Revenue bill (H. R. 16763) I. Alien income tax. II. Foreign corporation tax. III. Alien estate tax. IV. Witholding U.S. information. V. The normal tax. VI. The partnership provision. VII. Limited partnership. VIII. Losses in trade. IX. Facilitating judicial construction. Submitted on behalf of Investment bankers association of America... [1916?]
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UNITED STATES SENATE.

COMMITTEE ON FINANCE.

Memorandum Relative to Pending Revenue Bill (H. R. 16763).

I. Alien Income Tax.

II. Foreign Corporation Tax.

III. Alien Estate Tax.

IV. Witholding U. S. Information.

V. The Normal Tax.

VI. The Partnership Provision.

VII. Limited Partnership.

VIII. Losses in Trade.

IX. Facilitating Judicial Construction.

Submitted on Behalf of Investment Bankers Association of America.

REED & McCOOK,
Counsel.

ROBERT R. REED,
of Counsel.

Introductory.

The Investment Bankers Association of America comprises the investment bond houses of the country. Its interest is that of the distributor of securities. We are sometimes asked why this Association is always fighting the battles of some one else. The answer is simple. Probably no single interest is more closely identified with all the varying other interests of the country, or is as vitally and primarily concerned with the welfare of the country as a whole, with the fair distribution of wealth and of the burdens of taxation, with the stability of business conditions and the soundness of investment enterprises. The investment banker distributes securities. He markets bonds. His business is essentially and markedly competitive. He buys competitively at wholesale and sells competitively at retail. He obtains capital for the corporation public, municipal, quasi-public and private. This capital supplies industry, employs labor, creates and sustains business, creates and improves the various public utilities of the city, town and country. Capital enables the farmer to develop, improve and make productive the land that is the basis of all created wealth. The contraction of capital means the cessation of industry, the non-employment of labor, the suspension of productive activity throughout the country. It is unfortunate when this universal disaster ensues through any natural cause. It is almost criminal when it is caused by the mistakes of government, suspending natural laws and destroying the freedom of con-

tract which is essential to sound and enduring progress.

The investment banker knows how impossible it is to control the laws of trade, how disastrous it is to seek to control them by artificial means. The revenue futility and actual effect of tax statutes directed at any special form of capital are daily evidenced to him in the distribution of securities, *distributed along the lines of non-taxability.* He knows that an income tax is the one form of taxation that has not this effect, *though its administrative provisions may have, and its misuse as a means of penalizing special functions of capital is bound to have.* The investment banker seeks freedom from arbitrary conditions, freedom of contract, freedom to perform the function of his trade, to obtain competitively and distribute competitively the capital necessary to supply the continuous and insistent needs of America. He wishes to obtain this capital readily and cheaply and to distribute it economically.

When the supply of capital is contracted, he suffers, because the business and labor of the country are prostrated. When arbitrary conditions impose handicaps or confer special benefits on particular functions of capital, the result is disturbing if not disastrous to his business and to the country. His individual interest is to serve the financial needs of the community in which he works, his common interest is to serve the needs of the whole country.

Such in brief is the interest of the investment banker in the pending revenue bill. It is from this viewpoint that we, as counsel, are directed to approach the public questions involved in this bill.

I.

The Alien Interest Tax.

The most important single proposal which we wish to urge is that of eliminating from the pending bill every suggestion of a purpose to impose a tax on interest on debts owing to non-resident aliens, individual or corporate. We present herewith the printed argument already presented to the House Committee on this subject, further copies of which are available.

It is estimated we believe that this tax will produce a revenue of approximately $1,000,000. *We submit that its certain injury aside from its incalculable possible harm, is out of all proportion to any revenue that can be obtained under it.*

1. A very sharp distinction must be drawn between an alien ownership of property or the carrying on of a trade by an alien, and our obtaining capital abroad through investment securities sold to aliens.

It seems clear that the policy of our country in its present development is to discourage direct ownership and control by aliens of property or business in this country. It is equally important on the other hand—in fact a corollary to the foregoing—that the door be not entirely closed to the obtaining of foreign capital for American industry.

Taxing as we properly may every form of property that represents an actual ownership of business of the alien in this country, we must at the

same time leave it possible for industry and business, owned and controlled by Americans, to obtain foreign capital, either by direct loan or by the distribution of investment securities. Stock, especially preferred stock, has of course the commercial value and effect of bonds in obtaining investment capital. Its taxation in the hands of alien insurance and investing companies will automatically deprive us of this important part of our foreign market and will realize no revenue for the government. We must be free to borrow competitively in the markets of the world, to get and use profitably the capital of the world, to develop our industries and to create a surplus capital of our own for profitable investment in other lands. A nation, like an individual, needs credit to develop and extend its potentialities, to give continued profitable employment to labor, and to increase the productive capacity of its farms, its factories and its mineral resources.

The proposed tax would not make us a lending nation; it would destroy both our power to borrow and thereby destroy our power to lend. We have not as yet and for years to come are not likely to have a real net surplus of investment capital.

Emphasis should be laid on the necessary effect of this tax on our coveted position as a creditor nation, seeking particularly to finance South America in competition with Europe and also China, it is said, in co-operation with Europe. Even those who are most optimistic as to our ability to take back *all* our securities from Europe, recognize that the necessary effect of this movement and of our inability to get further capital from Europe, is to curtail if not destroy our power to

finance other countries. Without considering our relative position in the world-wide ruin that may yet ensue, it is inconceivable that we can in the near future return $4,000,000,000 capital to Europe and also lend extensively to other borrowing nations. If we can in substantial degree prevent that threatened drain from Europe, if we can continue to borrow on our best securities at low rates from the large fortunes that still survive in Europe, we can then very profitably loan to South America and China at attractive rates. In this way, and by protecting and advancing our position for some years to come, we may hope to realize our worthy ambition and be a creditor nation in fact as well as in name.

2. The figures available as to *railroad* securities show that securities having a par value of over $480,000,000 were returned to us between June and December, 1915. The figures on the latter date of such securities still outstanding was over $2,223,000,000. Figures to June, 1916, are in course of preparation and will undoubtedly show a continued heavy selling of our securities. This selling is even now having its effect despite our abnormal prosperity.

Though we have been able, under abnormal conditions, to take back close to $2,000,000,000 of our own corporate securities and to advance to Europe about $1,000,000,000 on her government securities, it by no means follows that we can take back the remaining $4,000,000,000 securities which Europe still holds. The controlling factor temporarily in our favor is that European governments have been

unable to compel a greater liquidation of American securities. The war itself, while it continues, protects us against the drain on our capital which seems to be the almost inevitable ultimate result of its devastation. The most reasonable explanation of the situation is found in the fact that, despite the appeals of patriotism and despite taxing statutes, thousands of foreign investors holding the inherited wealth of Europe are holding on to their American securities to save them from the ruin that seems threatening around them.

When the war ends, as of course it may do suddenly and without warning, and at any time, the situation will be reversed. Opportunities for profitable and safe investment will present themselves in Europe on every side. Our present international advantage will disappear. Europe will not only demand capital, as it now does, but it will attract it, which it is now unable to do, except at exorbitant interest. It will also seek to re-establish itself in South America. Every influence will operate to induce the quick liquidation of American securities, the immediate return to Europe of the $4,000,000,000 capital represented by those securities. Then is the time when we will see the real selling of our securities, the time when we will be least able to receive them, a time that may come suddenly any day. How are we to check this tendency, to meet the demand that it makes upon us? Everything that we can do must be done. Nothing in fact will avail, if our securities are unmarketable abroad, and they will be unmarketable if they are subject to taxation here. *The effect of the tax is automatic in compelling the liquidation of securities under normal conditions.* Its effect both during and after the war will be to compel the return to us of the balance of our securities, i. e., *which the warring nations are not able to force out, including those held in neutral countries including Holland.* We may of course be able to resell to Europe part of its own securities at whatever price we can get for them, but we cannot prevent the resale to us of our securities except temporarily by a tremendous reduction in market values, and we cannot market new securities if they are subject to an uncertain and increasing tax or to a surtax and inheritance tax here. Inevitably, if this tax is levied, all of our securities will be returned to us. Our markets will not be re-established until we have taken them. What is more important, there must be a practically complete cessation of new capital with all its attendant disasters. It is hardly necessary to say more, to emphasize the immediate peril involved in this proposal.

3. Can we, as seems to have been suggested in Washington, obtain an international agreement covering the taxation of alien holders of securities? The injury will be done before we can hope even to consider such an agreement.

What basis will there be for such an agreement? The former creditor nations of the world will be borrowing nations. They will make every effort, as they are now doing, to induce the liquidation of our securities, in order that their own citizens may be able to finance their domestic needs. To assume that they will seek to protect their own citizens against a tax on their American securities is to doubt the intelligence of which they are now giv-

ing very decided evidence. They will be the chief or only beneficiaries of our tax. They will welcome this tax. They will judge rightly that, though suicidal for ourselves, it is the most effective aid to them. They will probably continue to seek capital here, if there is any to be had, and will continue to covenant against their own taxes in order to attract such capital.

In dealing with this subject, the position and interest of each nation is peculiar to itself. Its command of capital and its need of capital are individual and distinct. One nation, like Great Britain prior to 1914, may be solely a lending nation. Its supply of capital far exceeds its own needs. Another nation, like the South American republics, is essentially a borrowing nation. A third nation, like ourselves to-day, is both a borrowing and a lending nation. We are able to lend to Europe, to South America and elsewhere, partly because of our great excess of exports over imports, very largely because Europe has not as yet been able to compel us to repay what we owe her.

It is said that these nations, at least England, now tax interest payable to non-resident aliens. Are there any figures available to show the amount of this tax? As we have said elsewhere, its incidence is accidental and rare. The only foreign loans placed in this country by actual distribution have been untaxed or "free of tax" by the issuing government. England except for the war, never had any occasion to seriously consider the question, because it never sought foreign capital. To the extent that it seeks it, or needs it, it makes the loan "tax-free," free that is of any English tax. That is the essential of such a loan, whether made by a government, corporation or individual.

4. *The whole question and the only question necessary to be considered, is whether the taxing government or its industries need or may need foreign capital. If they do, they must give the lender the assurance of repayment in full. This assurance is lacking if the government asserts the power to withhold either interest or principal under the guise of taxation.*

There can be no question of the fact that investors will not buy, nor under normal conditions retain, investment securities subject to an uncertain foreign tax. Every investment dealer, and many experienced investors, will testify to this fact, and also to the general fact that taxation is always a controlling influence upon the distribution of securities. This proposition is discussed and amplified in our separate argument on this point, copies of which have been furnished members of the Committee. This present discussion is directed to emphasizing the practical and immediate effect of the proposed tax.

5. The language of the present act applicable to non-resident aliens reads as follows:

> "a like tax shall be assessed, levied, collected, and paid annually upon the entire net income from all property owned and of every business, trade, or profession carried on in the United States by persons residing elsewhere."

A more accurate and inclusive sentence could hardly be framed to reach every properly taxable source of income belonging to an alien. It is contended with much force that it includes every kind

of income within the taxing power of Congress. See article in Columbia Law Review for June, by Amos J. Peaslee of the New York bar.

Whether or not one agrees with all the conclusions of the author, this article emphasizes the inclusive character of the provision quoted and suggests the need of having this present language construed and the powers of Congress defined by the Courts before making any further change. A case has already been commenced in the state courts of New York, which it is hoped will reach the United States Supreme Court in due course, raising the straight question as to the application of this provision to interest payable to an alien.

We do not agree with Mr. Peaslee that the present law should be amended. We think it is clear that the present law reaches as accurately as it can be reached, every properly taxable form of income received by a non-resident alien.

6. The suggestion has been made that it is unfair to exempt the alien holder of our securities from a tax which the resident holder has to bear.

This might be sound, if the tax in question was an excise tax on corporate interest, subject in its entirety to withholding. But the tax is an income tax levied on citizens and residents as such. The withholding of corporate interest is an administrative detail to reach a part of income of the taxable person. The taxable citizen has to pay this tax on his income, regardless of its character, whether he receives it in rent or in interest, *whether in foreign bonds or in American bonds, whether he lends it home or abroad.* The alien is not subject to any in-

come tax as such by our government. As to him, the proposed tax is only an excise tax on his American investments based on and payable out of his income from such investments. He presumably pays an income tax as such to his own government on these investments. He may conceivably already pay two income taxes, if he is a citizen of France living in England. As to him the tax is not a tax based on citizenship, nor on residence, each of which has a just foundation and a quid pro quo. It is wholly a tax, a penalizing tax, on the loan of money to American borrowers.

7. It may be said that the investment banker has a special interest in wishing to preserve a foreign market for American securities. This is true. He does not care about the foreign market as such, but about preserving existing capital and *a reserve* of available capital for American enterprise. That in fact is his whole interest. He is simply the instrument by which capital is made available. It is the interest of American industry, to preserve a continued supply of investment capital to meet the needs of this country, to prevent a sudden contraction of capital with its fatal results to industry and labor. It is plain that under no conditions are securities placed abroad which could with equal advantage be placed here. Market laws control this. We only borrow abroad when we have to do so. We should be free to borrow if we have to do so. To deny this, is to invite panic and industrial disaster.

It is also said that by seeking foreign capital, we are diminishing taxable American income. This argument refutes itself. It makes no differ-

ence whether our invested capital is in land or stocks or bonds, domestic or foreign; its income continues taxable. American income is the product of American property, capital or labor. So long as they are all profitably employed, American income is not diminished. Foreign capital is often essential to their employment. This argument opens the further suggestion, however, that as a business borrower normally makes a profit on his borrowed capital, every dollar on which we pay interest abroad in fact creates a taxable income here that would not exist without it. This is only another way of saying that we borrow for our own needs and profit.

II.

The Foreign Corporation Tax.

All that we have said applies with equal force to the tax on foreign corporations under Part II of Title I of the bill. We are not dealing here with "holding companies," but with—if we may use the phrase—incorporated reservoirs of foreign capital, the great insurance companies and investing companies, whose funds have supplied the sinews of enterprise and industry all over the world. There is neither reason nor policy in attempting to tax these foreign investors on interest or on dividends received from American bonds or stocks, preferred or common. Such a tax is simply destructive of the market. The securities subjected to it will be sold, and there will be no tax. The effect here will be much more immediate than with the individual investor. The increase of the excise

tax to two per cent. and the idea that this tax may be made subject to increase is bound to have a most destructive effect on this part of the available foreign capital. If the language of the present act be retained with respect to "persons residing elsewhere," the same language should we suggest be used with respect to foreign corporations. *They should be taxed only on income from property owned or a business carried on in the United States.* In fact it would seem simpler and wiser if the foreign corporations were taxed with the alien individual under Part I of Title I, and also made subject to withholding on rents and similar income. If the tax is levied either on interest or dividends, it should be collected by withholding. In this way conceivably the market might be retained, by enabling the American borrower to covenant against the tax.

III.

The Alien Estate Tax.

All that we have said applies also with cumulative force, to the provisions of Title II—the "Estate Tax"—of the pending bill, in so far as they tax stock in American corporations held by nonresident alien decedents or may be intended to tax American bonds so held. An alien may purchase a property or business in this country or a speculative stock subject to such tax. He will not purchase the better forms of real *investment* securities, stocks or bonds, any more than an American would purchase such an investment subject to a Mexican inheritance tax. The thing is im-

possible. *The tax statute is automatic in destroying the source, without raising any revenue.*

This is in fact the underlying truth that should control Congress on this whole subject of an alien tax. *We can levy it and get it on speculative property producing a relatively large income. We can levy it but will not get it on investments producing a relatively low income.* Its effect if applied to the latter is to prevent aliens from investing in them. Its net effect is to make us obtain our foreign capital (whatever is so available) on a speculative basis, to prevent us from obtaining such capital (in a much greater amount) on an investment basis. This means our gradual impoverishment. We will be paying more to Europe for the little that is obtainable on this basis, than we are getting from South America on an investment basis, assuming, of course, that we can in fact loan to South America.

This is assuming a rapid change without greater disaster, from one class of capital to another. This is impossible, the only "rapid" process in sight being the selling of investment securities now held abroad.

The true course indicated by the foregoing is the taxation of speculative properties owned by aliens. The present law comes as near to this ideal as any statute can hope to come. It should, we believe, be retained, and the same language used to cover the "estate tax" on aliens.

Both on the income tax and on the "estate tax," we are not inclined to question the policy of taxing "expatriated Americans." This can be readily taken care of as a separate matter.

IV.

Withholding vs. Information.

The provision of the pending bill requiring the withholding of the tax, particularly on corporate obligations, should be retained. There should be no prohibition of the tax-free covenant.

It is unnecessary to duplicate the printed argument submitted to the House Committee on this point, *copies of which are furnished herewith.* We quote as follows from its conclusion:

> "The real proponents of the desired change in the law are a few large corporate interests whose assumed authority to speak on the subject has given whatever color there is to the proposal. Both their viewpoint and their interest are, we believe, opposed to the general business interests of the country. This covenant involves a value of approximately $100,000,000, which is capitalized in the market value of over $10,000,000,000 bonds now outstanding, a value that would be destroyed by the proposed change. The tax-free covenant does not destroy the 'incidence of the tax'; it capitalizes and distributes the tax without burden to the taxpayer. The independent competitive corporate borrowers need to be left free to use this covenant. 'Withholding at the source' automatically collects practically the entire normal tax to which it is directed. It presents no incentive to evasion and little opportunity for it. Its alleged burden and cost is largely chargeable to the 'information'

system directed to the collection of the surtax, and would materially increase if it were also directed to the normal tax. Its high percentage in some instances is due to the number of exemptions from the withholding, to 'non-withholding'; this percentage will become prohibitive if the withholding is limited to one small class; it would be very low if the withholding were extended to all taxable classes.

The present system should be retained, possibly extended by permitting corporations to assume the withholding on all taxable interest on future bond issues. The clause declaring contracts relating to the tax invalid should, we urge, be omitted.

We respectfully urge the retention of the present system of withholding and the elimination of the clause declaring the contract invalid."

A printed discussion, evidently designed as an answer to our printed argument, has been prepared by A. C. Rearick, Esq., and A. C. Holcomb, Esq. Mr. Osgood, of Chicago, on behalf of important banking institutions of that city has replied effectively to this "discussion." (Statement of First National Bank of Chicago et al.)

The first ten pages of this "discussion" seem somewhat theoretical and remote from the question. The idea that "the debtor at the command of the creditor" (page 6) is *forced* to assume the latter's tax suggests that the corporation borrower is a very humble and obedient slave. Of course if the lender accompanied his *command* by a loan

at a rate that makes the assumption of the tax desirable by the borrower, his obedience is explained, and the tax is capitalized.

The suggestion (pages 12 and 15) that the present withholding is a sort of tentative impounding of the tax pending a final adjustment of liability, is to us an entirely new and we believe unfounded one. The income on which the tax is withheld is from its nature "net income." Though in rare and exceptional cases, later effects might conceivably arise, the argument based on this possibility indicates that our friends on the other side are hard up for new material to support their case. Mr. Osgood refutes this very effectively. (Chicago Bank Statement, page 13.)

We do not like to press any further the real answer to the argument (pages 13 and 15) based on the inconveniences caused by the numerous exemptions. A complete withholding on corporate interest would fall almost wholly on the paying corporations, but it would reduce to a fraction the heavy percentage cost of collection of which they complain. The figures given on page 30 emphasize our printed argument that this percentage varies according to the accident of each case, i. e., the percentage of bonds on which the tax is withheld. Nor would it be necessary or desirable in such a case to destroy the freedom of contract, under which the lender capitalizes his tax and the borrower receives it from him. *We hope the Committee will read our original argument on this.*

The whole argument as to "shifting the tax" and reaching the "recipient" with an individual levy and burden is fallacious. The bill is framed designedly and rightly upon the correct principle that the tax

paid by the corporation is distributed. This is the basis of the normal corporation tax and the exemption of dividends because the profits are taxed. It would be just as reasonable to urge that this tax also be levied on the individual and that the much-suffering corporation be relieved. The only difference between the tax as it affects the stockholder and the "tax-free' bondholder, is that with the former it is distributed in the diminution of the surplus which exists over and above his dividends, and with the latter it is distributed in the first instance by the contribution which he makes to the corporation for the "tax-free" covenant. *In both cases, the incidence of the tax is indirectly, but actually on the recipient of the income.*

The attempt to revive the suggestion (against their own former admissions) that the tax-free covenant had no value in bonds prior to 1913, is unfortunate. The admission on page 20, that prior to 1894, the clause had fallen into partial disuse, i. e., "during the period * * * in numerous cases the tax-free clause does not appear," leads us to the correct conclusion that it became again popular after 1894, in contemplation of a new income tax law (see Mr. Osgood's reply to this, page 23) and that as previously admitted it was a matter of design not of accident, was insisted upon by the creditors and "re-acted upon the interest rate." There is little more that can be said on this point.

The reference in the "Discussion," page 22, to the difference in market value between the "tax-free" and "non-tax-free" bonds would seem, but for the character of the proponents, to be recklessly misleading. After referring to the fact, which is a fact, that the highest quoted sale of the non-

tax-free bonds in 1916, was at 96, while that of the "tax-free" bonds was 95⅝, they say:

> "If the argument advanced is sound, it would seem that the tax-free bonds should have sold at a *substantially higher price* than the non-tax-free bonds. *The quotations certainly do not seem to support this view.*"

The italics are ours. Conceding whatever value there may be to the accidental fact cited, we say very strongly to the Committee and to these gentlemen, that the tax-free bonds have since 1914, and do now, day after day, as the normal and regular thing, sell at a "substantially higher price than the non-tax-free bonds," and we say further that had they taken the precaution to consult these regular and current quotations, they would not, we are sure, have made the statement, which is not true, that the "quotations certainly do not seem to support this view."

On January 18, 1916, there was one sale of the non-tax-free bonds at 96. They were quoted no bid, 96 asked. The tax-free bonds were quoted 95 bid, 96 asked; no sale. We do not know how this sale took place. It is quite possible, if not probable as such things are done, that a purchaser, desiring the non-tax-free bonds *because they were normally cheaper,* put in a market order for them and got them at the asking price.

For the information of the Committee, and supplementing the figures given by Mr. Osgood (Chicago Bank Statment, page 26), we give the following sale quotation for July, 1914, just before the European War (furnished by Harris, Forbes & Co.):

1914.

Date	Tax-Free	Sales	Non-Tax-Free	Sales
July 2,	96	1,000	94⅜	25,000
" 2,	96	5,000	——	——
" 3,	—	——	94⅜	5,000
" 6,	—	——	94⅜	5,000
" 6,	96	5,000	——	——
" 7,	96	1,900	94⅛	1,000
" 10,	96	10,000	94⅜	5,000
" 13,	—	——	94⅜	10,000
" 16,	95¾	5,000	——	——
" 22,	95½	1,000	——	——
" 27,	—	——	94	5,000
" 27,	—	——	94	5,000
" 29,	95½	5,000	——	——
" 29,	95½	2,000	——	——

And the following *recent* bid and asked prices from official sheets:

Date		Tax-Free Bid	Tax-Free Asked	Non-Tax-Free Bid	Non-Tax-Free Asked
May 20	(Sat.)	94¼	96		94½
May 27	"	95¼	95½		94
June 1	"	95⅛	95¼		94
June 10	"	94¼	95½		94
June 17	"	94¼	95¼		93½
June 24	"	9	94½		93⅜
July 7		93⅞	94⅛	93¾	94½
July 12		94⅜	95¼	93¾	94½
13					
July 15	(Sat.)	94⅜	94⅝		94
17		94¼	95¼		94
July 18		94¼	94⅜		94
July 19		94¼	94⅜		93¼

We feel quite sure that Mr. Rearick and Mr. Holcomb have not consulted the quotations except most casually. They will find that on different days, instance July 12, 1916, and Dec. 26, 1914, the non-tax-free bonds were on a parity or a bare fraction above the tax-free. They will also find—and we trust admit, to avoid any appearance of misleading—that the statement embodied in the Harris-Forbes & Co. memorandum, quoted in our original printed argument, page 9, is true, "that 1% is a conservative estimate of the difference in the selling value of these two kinds of bonds," i. e., those with the tax-free covenant and those without the tax-free covenant.

This value on over 10,000,000,000 bonds, i. e., $100,000,000 would evidently be destroyed by the proposed amendment of the law.

It is hard to follow the suggestion (p. 24), that the investor as to whom the tax is not withheld fixes the price for the investor as to whom it is withheld. The bankers who have to distribute the bonds find it impossible to distribute them on this theory. The demand for the tax-free bond is much greater, the market is wider, and the price is accordingly higher. The individual investor who is attracted to the tax-free bond because it is tax-free, who otherwise would put his money into stocks or mortgage notes, makes the higher price. The corporate investor who would buy in any event does not. Two bidders make a higher price than one and three bidders make a higher price than two. It seems to us that our opponents must realize this undeniable fact, however hard they try to make the busy Congressman forget it.

The occasional "injustice" by which the government gets more tax than it should (p. 26), cannot be very great, if the corporations only have to pay the tax on 25% of their interest payments, and the total tax is only $2,000,000. Our information is, that, thanks to the extensive system of exemptions which causes the expense, the corporations are saved this incidental injury except in very rare instances, trifling in amount.

The suggestion on page 27 that the wealthy taxpayer is able "to escape taxation" should be amended. He "escapes" only the "normal tax," and if he is investing in the Chicago & Northwestern bond, he pays well for the privilege.

As to the percentage of the interest on which the tax is paid (page 31), we understand that this is rapidly increasing, due to the return to this country of securities formerly held by non-taxable aliens. Representative bankers in New York and Chicago insist that 50% is the average ratio. If (page 32) $2,000,000 is the amount now annually collected at the source on corporate interest, this approximately is the amount which the corporations seeking this change would have Congress "shift" on the thousands of investors throughout the country now holding tax-free bonds. If the tax is doubled, the total will be $4,000,000, plus the burden involved. This burden now costs the fiscal agents, say $200,000 a year. To the small taxpayers it will equal the tax and be easily in value $2,000,000 a year. Add to this, the sense of injustice with the publicity given to the efforts made to accomplish this "injustice," and the law now almost popular will become distinctly unpopular with the most deserving and representative class of citizens.

In fact, if the tax increased to 2% is suddenly thrown back on the bondholder who has paid an enhanced price for the tax-free covenant, it is extremely probable that our corporation friends will hear a howl of protest from the Atlantic to the Pacific that will make them realize what they now ignore, the actual cost and value of the tax-free covenant.

The proposal of a plan for "information at the source" (pages 32-38), is as vague and inconclusive as it was in 1913. The argument magnifies the burdens of the present system and minimizes the burdens, dangers and actual loss involved in the proposed system. It magnifies the present burden on the fiscal agents, which large representative houses (our argument, pages 22-24) have offered to assume without any change except the usual coupon collection charge (the statement on page 31, line 7, of "discussion" seems an error) and it entirely ignores the much greater burden on the individual taxpayer. This burden on the taxable investor is, it seems desirable. We have, we believe, fully met this whole point in our original argument (pages 20-27) and practically nothing new is urged. Is the Treasury Department willing to do away with the withholding against taxable non-residents? We think not.

We understand that Mr. Holcomb and Mr. Rearick present this argument as individual volunteers and do not represent even the much abused Tax Association Committee. We may be pardoned if we share Mr. Osgood's view as to their actual interest. (Chicago Bank Statement, page 2.) We doubt whether all the interested members of the Tax Association Committee would endorse their

argument. Professor Seligman, we understand, has recently announced views which are in conflict with those of the other members of the Committee.

We know that the Senate Committee will look at this matter from the viewpoint of the Government and the taxpayer. Fortunately the tax-free covenant was based on the assumption that Congress would adopt the withholding plan as beyond all question best for the government, and justice requires that this plan be not abandoned upon the suggestion of the few great corporate interests which seem to be responsible for this proposal.

We particularly urge upon the Committee what has seemed to us to be the conclusive argument in favor of the "freedom of contract" represented by the so-called tax-free covenant. With few and powerful exceptions,—the great railroads and established monopolies—the industrial interests of the country require the free use of this covenant. They need every inducement possible to facilitate the marketing of their securities. They need greatly this one inducement which the investor demands. It is the only selling argument, so to speak, that a dealer has to sell corporate bonds, in competition with municipal bonds and with mortgage notes of city or country. It should be borne in mind that the ownership certificate required by the Treasury Department is a burden that reaches the smallest non-taxable investor, who turns to other forms of investment to escape it. The tax-free covenant is the chief salvation of corporate securities with tens of thousands of small taxable investors. What the sale of these securities means to the industry and labor of the country need not be emphasized. A cessation of capital means a cessation of industry,

the non-employment of labor. It is the cause and beginning of long periods of depression and of the initial panics. A cessation of capital flowing to new and competitive industries will strengthen the hands of established monopolies which this Congress—or its predecessor—has seemed to threaten so hard and, according to some, hurt so little. Believing as we do, that freedom of contract is the one essential to "business freedom" and competitive industry, we very strongly protest on behalf of a membership in all parts of the country, against the efforts being made to destroy the financial freedom of these smaller industries and utilities seeking new capital to compete with those that are now established. This in substance is the issue underlying this phase of the pending bill. We trust the Committee will read our printed argument on this point, pages 12 to 16.

V.

The Normal Tax.

Noting the widespread criticism directed at the increase of the normal tax to 2%, we urge a recasting of the bill in this respect. This increase affects all taxpayers whose incomes run between $3,000 or $4,000 and $20,000. It will rest most heavily and be most unpopular with those whose incomes are below $10,000. This class of taxpayers is very large. It is perhaps the most representative and influential class of citizens in the country. The bill in its present form merits their criticism and protest. They say justly that before this "surtax" is placed on them, the normal tax should be

placed on recipients of income between $1,500 and $3,000 who are unmarried or childless. The bill proclaims this injustice. *The former surtax is made the normal tax, and yet there is no lowering of the exemption.*

The best way to meet a charge of injustice is to do justice. A perfectly just plan disarms criticism.

In the first place the normal tax of 1% should, we urge, remain. It should be fixed and permanent as a basis of the tax and should apply to all income reasonably capable of bearing it. The taxability of income should be determined primarily by the number of persons dependent upon it. A tax upon an income supporting four persons is a tax on four persons, not on one. This principle should run throughout the law, and be recognized in the exemptions. It should appear in the published figures showing the number of persons actually paying the income tax. A single person enjoying an income over $1,500 should and would, without complaint, gladly pay his or her 1% on the excess to the government. A married couple without children enjoying an income over $2,500 should and would recognize the justice of the tax. Its manifest justice would silence any real objection.

We are dealing here not with the very poor and the very rich, but with practically *one great class,* constituting the bulk of the intelligence and substance of the country. An arbitrary and unjust line is drawn, which divides the individuals in this class between those who are taxed and those who are not taxed. The father of a family, spending every dollar of a $5,000 income on rent, clothes, college, school and insurance may be willing to pay his $10 or (if he is a widower) $20, which he now has to pay. So, also the widow who has to pay on the excess over $3,000. They are not willing that another man or woman in the office or in the town, unmarried or without children, shall enjoy an income of $3,000 and pay nothing out of his abundance. This inequity of the present law is a matter of daily comment in every part of the country. It is emphasized and driven home by the increase of the pending bill, doubling the normal tax without lowering the exemption. The $20 becomes $40, but the easy-living bachelor or spinster goes free. This injustice should be met on a basis of justice, by a $1,000 or $1,500 exemption with an additional exemption of $500 for each dependent. Nothing, we take it, would be more popular with the best citizens of the country than this tardy recognition of the elementary justice which is now ignored.

To meet the other side of the problem half way, the surtax should be lowered, but not so far as to become the normal tax. It should, we suggest, begin at $10,000.

We would then have a normal tax beginning say at $1,000 or $1,500, an exemption of $1,000 for a wife, and of $500 for each child or other actual dependent. This would give us the figures showing the total number of persons in fact contributing to the income tax and enjoying a substantial income. It would be a constant criterion of our social and industrial progress. On top of this, we would have a surtax commencing say at $10,000 and graduated according to ability as under the present law and pending bill.

One important advantage in retaining the normal tax of 1% lies in its value as a basis in dealing

with the withholding questions and with the effects of the possible alien income tax. This has a practical bearing which should not be overlooked if Congress is to consider the incidental effects of the tax, effects which are apt to be much greater than the revenue sought by the Government. While a 2% withholding tax could of course be borne by the corporations under their tax-free covenant and certainly should not be paid by those who paid for the covenants, there is no doubt that the increased amount would *seem* unjust to the corporations, and that to place it on the bondholders would *be* unjust and arouse a widespread and powerful protest against the law.

So also as to the normal alien tax, if it could be fixed and retained at 1% and made subject to withholding both as to individuals and corporations, as to interest and dividends, the foreign market for American securities could be protected—subject of course to the more destructive effect of the surtax. The increase of the normal tax, both as to individuals and corporations, suggests the future uncertainty as to the extent of this tax. This uncertainty is a very potent factor in destroying the market for foreign securities.

All of these considerations are met if the normal tax can be retained at 1%, if this rate can be made the fixed permanent basis of the income tax, the surtax commencing at say $10,000 and being raised or lowered as exigency requires. If the normal tax commenced at $1,500, the surtax might even be made to commence at $5,000 or $7,000. This would be preferable to the present bill.

We urge, first that the normal tax be retained at 1%, second, that the exemption be lowered to

$1,500, with additional exemptions for a wife and other dependents, and third, that the surtax commence at $10,000 or, if need be, lower. We emphasize the fact that these fundamental changes concern primarily one class of citizens, the best in the country and remove the unjust discriminations of the present law between different individuals in this class.

VI.

The Partnership Provision.

We quote as follows from subdivision (e) of Section 8 of the pending bill, italicizing the new provisions:

> "Persons carrying on business in partnership shall be liable for income tax only in their individual capacity and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this title, and any such partnership, when requested by the Commissioner of Internal Revenue, or any district collector, shall render a correct return of the earnings, profits, and income of the partnership, *setting forth the items of gross income and the deductions allowed by this title,* and the names of the individuals who would be entitled to the net earnings, profits and income, if distributed."

The Treasury Department, after repeated changes of its position, now holds that under the language of the present act an individual partner must pay his normal income tax on his net share of partnership profits, *regardless of the source of the partnership income,* and that when two or more persons are doing business jointly as partners, jointly receiving income from municipal bonds and dividends from corporate stock, the individual members have to include in their income tax their share of the income from municipal bonds and dividends from corporate stock; also that coupons payable to a partnership are not payable to "persons subject to the tax" and are not subject to withholding, so that a partnership carrying corporate bonds with the tax-free covenant loses the benefit of this covenant. In the case of dividends received on corporate stock the partnership (i. e., its members) is subject to the double tax, which is intended only for corporations. In the case of income from municipal bonds, the partnership (i. e., its members) is taxed upon such income, although a corporation receiving such income is not taxed upon it. (See T. D. 2337.)

We understand that the ruling of the Treasury Department is in this respect totally at variance with the intent of the framers of the present law.

We believe that it is the intent of the amendment in the pending bill to remove if possible the ambiguity upon which the Treasury ruling rests. We feel sure that it is not the intent of the amendment to make the bill strengthen the Department's position. We believe that the Treasury Department itself recognizes the manifest injustice of its ruling, but feels that it is necessary under the act.

Our first impression on reading the bill was that the amendment (*the words in italics above*) did remove this ambiguity. Closer study has reversed this impression. We have received a memoradum prepared by prominent counsel in Boston, taking the position that the amendment, if anything, would tend to strengthen if not to support the view taken by the Department under the present act. They take the position that "the deductions allowed by this title" do not include income from municipal bonds, which is simply made "exempt" under Section 4. This income, though exempt from taxation, if received by a taxable person, would on the Department's theory not be exempt as an item of partnership income, the tax being on the partner's share of the profits and not upon the income of the partnership as such. These counsel also take the position that "the deductions allowed by this title" are the deductions specified in subdivision (a) of Section 5 and would not include the "credits" specified in subdivisions (b) and (c) of such section. They suggest (as we understand it) that this part of the bill be amended to read substantially as follows:

> "Any such partnership, when requested by the Commissioner of Internal Revenue, or any district collector, shall render a correct return of the earnings, profits, and income of the partnership, setting forth the items of gross income, *except income exempt under Section 4 of this title, together with* the deductions *and credits* allowed by this title."

We had previously suggested to Senator Williams an alternative covering this same possible

ambiguity. Our suggestion was and is that the following provision be added to subdivision (c) as first above quoted:

> "and for the purposes of the normal tax only of such individual partners, there shall be allowed in such partnership returns the credits specified by subdivisions (b) and (c) of Section 5. All income exempt under Section 4 shall be excluded from such partnership return."

This provision should, as stated, be added to the present paragraph first above quoted. It may perhaps meet the matter more fully than the amendments suggested in Boston, especially in making it clear that these credits apply only to the normal tax. One or the other of these amendments, substantially, should be made, if this very plain injustice is to be avoided.

VII.

Limited Partnerships.

Despite the precise wording of the present act, which is repeated in the pending bill (Title I, Part II), specifically excepting "partnerships" from the corporation tax, the Treasury Department has held, with some evidences of hesitancy, that "limited partnerships" are taxable as "associations." A limited partnership in its usual and simplest form is nothing more nor less than a general partnership having under authority of statute one or more

special partners, whose liability is limited to the income contributed. Generally speaking, the partnership assets and income are owned jointly by the general partners and the special partner's interest and ownership is subject to the terms of his agreement. The injustice of this ruling is manifest. It subjects the limited partnership to the double tax on dividends received from corporate stock and also deprives it of whatever benefit there may be in the withholding provisions on corporate interest.

We appreciate the view that the fact that the Department makes an erroneous ruling is no reason why Congress should keep changing the law to rebut such rulings. We believe, however, that a proper respect for the Department itself requires us to take the view that there must be some ambiguity in the law and that the fact that it makes a ruling opposed to the real intent of the act is sufficient reason why Congress should make the act more clear. Perhaps the simplest and most effective way to make the act clear and consistent on this point would be to add to the partnership paragraph substantially the following:

> "The fact that such partnership has one or more special partners, or partners not having a joint ownership of the income of the partnership, shall not affect the character of such income as the property of the partners having such ownership, nor shall such partnership be deemed to be a corporation or association under any other provision of this title."

VIII.

Losses in Trade.

The pending bill very properly attempts to correct the ambiguity which is said to be the cause of the present Treasury ruling holding that losses incurred in the purchase and sale of property are not deductible unless the individual incurring such losses is actually engaged in a regular calling or trade in which such losses occurred. This ruling has the effect of preventing an individual from deducting a loss actually sustained in one or more individual trades or transactions which are not connected with his regular business, although under the more specific language of subsection B (present act) he would be clearly taxable on a profit in any such transaction. Our own feeling is that the ruling is erroneous and that the present law if properly construed would do substantial justice in the premises. We also beg leave to doubt whether or not the amendment does not really restrict the present law and concede to the decision of the Treasury Department a certain amount of continued injustice.

We believe it should be fundamental in an income tax law that a taxpayer should not be required to pay a tax except upon his net income, and that losses, however incurred, should be deductible from his gross income in determining the amount. Waiving whatever question there may be as to the taxability of profits accruing from the sale of property at an increased price on the view that such a profit represents an increase of principal and not income, we respectfully suggest as a matter of very plain justice, that *if on any transaction a profit would be taxable, a loss should be deductible,* and this regardless whether or not the amount of such loss exceeds the amount of any similar profit for the particular year.

The tax is, of course, a continuing tax. The profits of one year may be entirely swept away by the losses of the following year. A tax may be paid on the profit and yet no deduction allowed for the losses.

It seems to us that this matter should be entirely taken care of by paragraph fourth of subdivision (a) of Section 5, and that this paragraph should include the effective words of Section 2, which define taxable income as including:

> "gains, profits and income derived from * * * *sales, or dealings in property,* whether real or personal, or growing out of the ownership or use of or interest in real or personal property."

We submit that paragraph fifth should be eliminated and that paragraph fourth should read substantially as follows:

> "losses actually sustained during the year incurred in any *profession, vocation,* business, trade *or commerce, or sales, or dealings in property, whether real or personal, or growing out of the ownership or use of or interest in real or personal property,* or arising from fire, storm, shipwreck, or other casuality, or from theft, when not compensated for by insurance or otherwise."

Attention should, we think, also be called to a possible ambiguity in paragraph fifth, as it now reads. The last clause "not exceeding profits arising therefrom" should, we think, be amended by

adding the words "or from similar transactions." Of course a loss does not arise from the *same* individual transaction as a profit. One transaction shows a profit, another a loss. The provision as it now stands should be given a liberal construction so as to permit the deduction of losses sustained in similar transactions. We submit, however, that this provision should be made more clear.

IX.

Facilitating Judicial Construction of Law.

We have urged upon Senator Williams the inclusion of some provision in the act, making it possible to immediately determine any disputed question under it by recourse to the courts. The general rule is that there can be no recourse to the courts until the tax has actually been paid and until after application for its refund by the Department. This means under this act that the validity of a ruling can hardly get into the courts for months or possibly a year after it becomes effective. It is also a fact, unfortunately, that an individual taxpayer hesitates to bring a "test suit" on his own individual tax. He dislikes the publicity and is also deterred by the thought that someone else will test the question for him. The result is that despite wide and strong protests against certain Treasury rulings, and despite the fact that nearly everyone outside of the Department has felt that some of these rulings were unsound, there have been few test suits under the law and none at all on such important matters as the "losses in trade" ruling or the "partnership" rul-

ings. The government has collected a substantial amount of money which probably does not belong to it. Although this amount is perhaps fairly large, we submit that it is not large enough to compensate for the general criticism which has been directed against the Department on account of these rulings. The Department itself, we believe, would be glad to have its position sustained by the courts or if it is in error, to have its position corrected. We suggest that some provision be inserted in the law permitting any taxpayer to bring a suit to restrain the enforcement of a ruling upon obtaining a certificate from the Secretary of the Treasury that the government is willing that such a suit should be brought for the purpose of determining the legality of the ruling. This is a tentative suggestion. We believe that its purpose should be effected by some provision in the new bill.

CLOSING.

We again respectfully request the Committee to consider our separate printed arguments on the alien interest tax and on the withholding question, this brief being on those most important matters merely supplemental.

Respectfully submitted,

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ROBERT R. REED,
of Counsel.

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END OF
TITLE